Office of Chief Counsel
Internal Revenue Service

memorandum

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RTBennett

date: December 21,2001

to: [redacted], Team Coordinator

from: William F. Halley, Associate Area Counsel, Newark, NJ

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subject: **Dual consolidated loss exception: Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2)**
Taxpayer: [redacted]
Tax years: ending [redacted]
EIN: [redacted]
UIL: 1503.04-00

Facts.

The taxpayer, [redacted] ("[redacted]") is a domestic corporation that was incorporated in the United States in [redacted]. [redacted] was created to facilitate a demerger of the United Kingdom corporation [redacted] PLC ("[redacted]"). [redacted] is a holding company which wholly owns [redacted] another domestic holding company. [redacted] in turn owns numerous corporations operating in the United States which were previously indirectly owned by [redacted]. [redacted] also wholly owns [redacted], a U.K. holding company.

[redacted]

In tax years ending [redacted] and [redacted] [redacted]
It is believed that [redacted] was not part of any group for group relief purposes in the U.K. at any time during the tax years ending [redacted], [redacted] and [redacted].

[redacted] filed consolidated returns in the U.S. for the years ending [redacted], [redacted] and [redacted]. On its returns, [redacted] reported that

[redacted] itself earned either extremely little profit or loss. [redacted] reported that it received a management fee from [redacted]. The management fee income essentially offset its expenses. Currently, the examination team is analyzing whether [redacted], and not [redacted], was actually performing the management services. If this is the case, the examination team is considering making adjustments which would result alternatively in (1) a management fee being paid by [redacted] to [redacted] or (2) allocating expenses reported by [redacted], but determined to be attributable to [redacted], to [redacted].

Either of these adjustments would create a loss in each of the three years for [redacted]. The examination team would propose that [redacted] is a "dual resident corporation" under section 1503 and its losses, as "dual consolidated losses," could not be used to offset the income of any of its other U.S. affiliates.

As discussed in more detail below, [redacted] argues that these losses would meet the requirements of an exception to the definition of a dual consolidated loss under the regulations.

Issue.

Whether the taxpayer, a dual resident corporation, has met its burden in proving that its losses meet the exception to the definition of a dual consolidated loss under Treas. Reg. §1.1503-(2)(c)(5)(ii)(A)(1) and (2)?

Conclusion.

The taxpayer has not met its burden of proving that its losses meet the exception to the definition of a dual consolidated loss under Treas. Reg. §1.1503-(2)(c)(5)(ii)(A)(1) and (2).

Discussion.

A. U.S. dual consolidated loss rules.

A corporation that is created or organized in the United States or under the laws of the United States or any State is a "U.S. corporation" or "domestic corporation." Section 7701(a)(3)

and (4).[1] The U.S. taxes a U.S. corporation on its worldwide income and allows it to deduct losses wherever incurred. The U.S. allows U.S. corporations to file consolidated tax returns with other U.S. corporations that are commonly owned. Section 1501. When two or more U.S. corporations file a consolidated tax return, losses of one corporation generally may reduce or eliminate tax on income that another corporation earns.

Certain foreign countries use criteria other than place of incorporation to determine whether corporations are residents for their own tax purposes. For example, the United Kingdom treats a corporation as a domestic resident if the corporation is managed or controlled there. General Explanation of the Tax Reform Act of 1986, p.1063; De Beers Consolidated Mines Ltd. v. Howe, 95 L.T. 221 (1906). A corporation that is incorporated in the United States but managed and controlled in a foreign country may be subject to tax on its worldwide income in both countries. Under the U.S. dual consolidated loss rules, such a corporation is referred to as a "dual resident corporation."

A "dual resident corporation" is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. Treas. Reg. §1.1503-2(c)(2). If a dual resident corporation is a resident of a foreign country in which the law permits the losses of such corporation to be used to offset the income of other commonly controlled resident corporations then the dual resident corporation may be able to use a single economic loss to offset two separate items of income, i.e. separately offsetting the income of its affiliates which are residents in the United States and again offsetting the income of its affiliates which are residents only in the foreign country. This practice is referred to as "double dipping." British Car Auctions, Inc. v. United States, 35 Fed Cl. 123, 125 (1996), aff'd per curiam, 116 F.3d 1497 (Fed Cir. 1997).

The United States Congress addressed the practice of double dipping in the Tax Reform Act of 1986 with the enactment of section 1503(d). Section 1503(d)(1) states:

> "The dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable

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[1]Unless otherwise indicated, all "section" references denote the Internal Revenue Code of 1986 as in effect for the years in issue.

year."

A dual consolidated loss is "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis." Section 1503(d)(2)(A).

A dual consolidated loss does not include a net operating loss incurred by a dual resident corporation in a foreign country whose income tax laws (1) do not permit the dual resident corporation to use its income to offset the income of any other person that is recognized in the same taxable year in which the losses, expenses or deductions are incurred and (2) do not permit the losses, expenses or deductions of the dual resident corporation to be carried over or back to be used by any means, to offset the income of any other person in other taxable years. Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2). The taxpayer bears the burden of proving that no other person could possibly use the losses to offset income at any time. The Service has stated that "this exception rarely applies." FSA 200101007 (September 28, 2000).[2] In fact, we are not aware of any case in which a taxpayer has met the burden and the exception applied.

The regulations contain a "mirror legislation" provision. Treas. Reg. §1.1503-2(c)(15)(iv). This generally provides that where the income tax laws of a foreign country deny the use of losses, expenses, or deductions of a dual resident corporation to offset the income of another person because the dual resident corporation is also subject to income taxation by another country on its worldwide or residence basis, the dual resident corporation shall be treated as if it actually had offset its dual consolidated loss against the income of another person in such foreign country. Id.. The validity of the mirror legislation was confirmed in British Car, 35 Fed. Cl. at 133.

Shortly after the enactment of section 1503(d) in 1986, the United Kingdom enacted it own dual consolidated loss rules. These rules are contained within the Income and Corporation Tax Act ("ICTA") at section 404. Effective for the 1987 tax year, under United Kingdom law,

> Notwithstanding any other provision of this Chapter, no loss or other amount shall be available for set off by way of group relief in accordance with

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[2]Field Service Advice can not be cited or used as precedent. Section 6110(k)(3).

> section 403 if, in the material accounting period of the company which would otherwise be the surrendering company, that company is for purposes of this section a dual resident investing company. ICTA §404.[3]

This may have the effect of the loss being disallowed in both countries. British Car, 35 Fed. Cl. at 130. A taxpayer may not rely solely on a foreign country's mirror legislation to prove that its losses are not dual consolidated losses. Id.

The regulations under section 1503 provide two means by which the taxpayer can utilize a dual consolidated loss. First, a taxpayer may use a dual consolidate loss to offset the income of affiliated domestic corporations if it files an agreement with its tax return stating that it will not use the dual consolidated loss to offset the income of another person under foreign law. Treas. Reg. §1.1503-2(g)(2). However, a taxpayer can not utilize this exception if the foreign country at issue has enacted its own mirror legislation. British Car, 135 Fed. Cl. at 126, n.1; Treas. Reg. §1.1503-2(c)(16), ex. 5. Second, a taxpayer may avoid the dual consolidated loss rules if the United States and the foreign country have entered into a bilateral agreement permitting it. Treas. Reg. §1.1503-2(g)(1). The United States has not entered into any such agreement with any country to date.

B. Examination team's position.

The examination team submitted a memorandum to [redacted] in [redacted]. In its memorandum, the Examination team informed [redacted] that it was analyzing the effect of the dual consolidated loss rules on the management expenses in tax years ending [redacted], [redacted] and [redacted]. The examination team informed [redacted] that if [redacted] performed any management services for [redacted] that an adjustment may be necessary. The proposed adjustment would create loss to [redacted] which would be considered a dual consolidated loss and therefore could not be used by [redacted] to offset the income of any of its U.S. affiliates.

C. [redacted]'s response to examination team.

By memorandum dated [redacted], [redacted] provided its response to the examination team's memorandum. The memorandum was prepared by the accounting firm [redacted]. The memorandum assumes that the adjustments contemplated by examination are made

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[3]Unless otherwise indicated, all references to the "ICTA" denote the Income and Corporation Tax Act of 1988 as in effect for the years in issue.

and that [redacted] is in a loss position during the years at issue.

In its memorandum, [redacted] states, without authority, that [redacted] is a dual resident investing company under the U.K. mirror legislation of ICTA §404. [redacted] states that it is a dual resident investing company "based on its understanding of [redacted]." [redacted] argues that its losses fall under the exception set forth in Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2). [redacted] states that "[[redacted] is] proposing that the third exception [Treas. Reg. 1.1503-2(c)(5)(ii)(A)(1) and (2)] should be available to [redacted] on the basis that there are other UK tax provisions (aside from 'mirror legislation') which would have denied other UK group entities from utilizing these losses on a current year, carried back or carried forward basis."

[redacted] acknowledges that it bears the burden on this issue. [redacted] also acknowledges that it can not rely solely on the mirror legislation in the U.K. to meet its burden.

[redacted] argues that the losses are not covered by the U.S. dual consolidated loss rules because of the exception cited above, Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2). [redacted] claims that U.K. group relief provisions do not apply to it in years [redacted] through [redacted] because it was not part of a group in the U.K. Therefore, it is necessary to determine if [redacted] could carryback or carryforward the losses to be used by other U.K. companies.

[redacted] claims that U.K. group relief provisions would not allow it to carry forward the losses so that any other U.K. entity could use these losses. [redacted] states that group relief is only available on a current year basis and since [redacted] was not part of any group in the years at issue it could not have utilized the losses.

Next, [redacted] states that certain U.K. reorganization provisions allow net operating losses of U.K. entities to be carried forward to be used against the income of other group entities. Citing ICTA §343, [redacted] claims that this is only possible with respect to the transfer of a trading loss from a trade. Without citing any authority, [redacted] makes the assertion that it is an "investment company." It further assumes, also without authority, that excess management expenses are not trading losses. [redacted] concludes that since it is an investment company and excess management expenses are at issue it could not carry forward the losses under the reorganization provisions. Presumably, [redacted] argues that since it is not a trading company and does not have trading losses it can not carry forward its losses to be used against the income of other entities. [redacted] concludes with the blanket assertion that "[t]here are no UK tax provisions

which provide for the transfer of excess management expenses to another UK group entity for use on a carried back or carried forward basis."

D. Relevant U.K. law.

A U.K. company carrying on a trade may generally carryforward or carryback a loss to set off trading income from that trade. ICTA §393(1) and (2). U.K. law also provides for "group relief" between related companies. Under the group relief provisions, trading losses and certain other amounts eligible for relief incurred in an accounting period may be surrendered by a company ("surrendering company") and allowed to another related company ("claimant company") to offset the profits of the claimant company. ICTA §403(1). The plain language of ICTA §403(1) does not make any distinction between trading companies and investment companies. The surrendering company and the claimant company must be members of the same group. ICTA §402(2). Generally, a group exists if one company is a 75% subsidiary of another or both companies are 75% subsidiaries of a third company. ICTA §413(3)(a).

ICTA §343 concerns "company reconstructions," i.e. reorganizations. ICTA §343(1) concerns the situation where one company ("the predecessor") ceases to carry on a trade and another company ("the successor") begins to carry it on and the trade, or a 75% or more interest in the trade belongs to the same persons as the trade or interest belonged to within a year prior to the transfer. ICTA §343(3) provides for carry forward of trading losses where ICTA §343(1) applies and one company succeeds to the operations of another company. Under ICTA §343(3), generally the successor is entitled to claim a loss which the predecessor would have been entitled to claim if it had continued the trade.

E. [redacted] has not met its burden of proving that its losses meet the exception under Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2).

Based on our review of [redacted]'s memorandum and our own research, we conclude that [redacted] has not met its heavy burden of proving that its losses meet the exception under Treas. Reg. §1.1503-2(c)(5)(ii)(A)(1) and (2). As a threshold matter, the burden is extremely difficult to meet since it requires the taxpayer to prove a negative, i.e. it will not be able to use the loss to offset the income of any other person at any time under the income tax laws of the foreign country. Moreover, the taxpayer can not rely on the mirror legislation alone to meet its

burden. British Car, 35 Fed. Cl. at 130.

[redacted] initially argues that it was not part of any group during the years at issue for U.K. group relief purposes and therefore could not use the losses to offset the income of other entities during those years. [redacted] is correct on this point.

However, we do not believe that [redacted] has satisfactorily argued that the income tax laws of the U.K. prevent it from using the losses on a carry forward or carry back basis to offset the income of another person. For example, [redacted] admits that trading losses of a trading company can be carried forward and used by another entity in a reorganization under ICTA §343. Fundamental to [redacted]'s argument that the reorganization provisions do not apply to its situation are [redacted]'s contentions that (1) [redacted] is an investment company and (2) the losses at issue result from management expenses, i.e. non-trading losses. [redacted] does not cite any authority to support its contention that it is an investment company. This alone compels the conclusion that [redacted] has not met its burden.

It is possible to surmise that [redacted] is arguing that since it is a "dual resident investing company" under the mirror legislation it is therefore an "investment company." Without any support, this argument would also fail. First, a taxpayer may not rely solely on the mirror legislation to prove that it can not use the loss. Second, if [redacted]'s position is that a dual resident investing company (under the U.K. mirror legislation) and an investment company (under U.K. law independent of the mirror legislation) are synonymous, it is incorrect. The definition of an investing company is different from the definition of an investment company.[4] [redacted] asserts, without explanation, that it is a dual resident investing company "based on its understanding of [redacted]." [redacted] fails to provide any explanation for this conclusion. Tellingly, [redacted] fails to cite any U.K. authority to establish that it could not possibly be considered a trading company, or that it is an investment company.

[redacted]'s apparent argument that it is an investment company because it is a dual resident investing company may actually be undermined by the same U.K. statute upon which it relies. ICTA §404(6) provides certain situations in which a "trading" company

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[4]ICTA §130 defines an "investment company" as "any company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom..."

will be considered an "investing" company *"for purposes of this section* [the U.K. mirror legislation]." (emphasis added). For example, according to ICTA §404(6)(a)(i), a dual resident company, during an accounting period in which it is a trading company, which carries on a trade of such a description that its main function, or one or its main functions, consists of acquiring and holding, directly or indirectly shares in other companies (including companies not resident in the UK), with which the dual resident company is connected within the terms of ICTA §839, is considered an investing company.[5] A dual resident investing company is not necessarily an investment company for purposes other than ICTA §404. ICTA §404(6)(a)(i) implies that certain holding companies can be trading companies, but for purposes of ICTA §404 alone will be considered investing companies. Also, the Inland Revenue Company Taxation Manual at CT3456 provides that ICTA §404(6) was intended to "catch a company which carries on a trade such as providing management services..." In other words, simply because a U.K. company is caught within the mirror legislation of ICTA §404 does not necessarily mean that it is an "investment company" for purposes other than the mirror legislation. Therefore, the possibility exists that [redacted] could be considered a trading company under U.K. law for purposes unrelated to the mirror legislation.

[redacted] proposes that the management expenses at issue are not trading losses. In discussing management expenses, [redacted] cites only ICTA §75. ICTA §75 does not state that all management expenses are not trading losses. Rather, it states that investment companies may deduct management expenses from their investment income. ICTA §75(1). A trading company may still use management expenses to offset trading income. British Tax Guide, CCH (1991), ¶188-800. Management expenses may be partly related to investment and partly to trade. British Tax Guide, at ¶188-825. Since [redacted] has not shown that it is an investment company nor that the expenses relate to solely to investment income, ICTA §75 is not necessarily applicable.

In conclusion, [redacted] has not met its heavy burden in proving

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[5]ICTA §839(5)(a) provides that a company is connected with another company "if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other." ICTA §416 provides that "control" is defined under ICTA §416. ICTA §416(2)(a) provides that a person may exercise control over a company if he possesses or is entitled to acquire the greater part of the share capital or issued capital of the company or of the voting power in the company."

that the exception under Treas. Reg. §1.1503-(c)(5)(ii)(A)(1) and (2) applies. At this time, we will not speculate on additional arguments that [redacted] may pursue under U.K. law in an attempt to meet the exception to the definition of a dual consolidated loss. In the event that [redacted] provides any additional support for its contention, we recommend that you contact our office for further review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please be advised that this advisory memorandum is subject to post review by our National Office. If you have any questions, please contact attorney Robert T. Bennett of our office at (973) 645-3244.

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